No. 10240

In the United States Circuit Court of Appeals for the Ninth Circuit

Daily Journal Company, petitioner

v.

Commissioner of Internal Revenue, respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The only previous opinion in this case is the memorandum opinion of the United States Board of Tax Appeals (R. 31–46), which is not reported.

JURISDICTION

The petition for review herein involves deficiencies in corporate income taxes in the aggregate amount of $991.05 for the taxable years 1936–1938 and personal holding company surtaxes in the aggregate sum of $15,254.46 for the years 1937 and 1938 as asserted by the Commissioner of Internal Revenue in notice of deficiency mailed July 3, 1940. (R. 7–17, 31.) Within ninety days thereafter and on October 2, 1940, the

taxpayer filed a petition with the Board of Tax Appeals for a redetermination of those deficiencies under the provisions of Section 272 of the Internal Revenue Code. (R. 2–17.) The final order and decision of the Board of Tax Appeals, sustaining the deficiencies in question, was entered on May 12, 1942. (R. 46.) The case is brought to this Court by petition for review filed August 6, 1942 (R. 148–150), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code. As of October 22, 1942, by Section 504 of the Revenue Act of 1942, the name of the Board of Tax Appeals was changed to The Tax Court of the United States. Although the decision of the Board and the petition for review were both filed prior to that date, since the record was prepared and printed subsequent thereto by the clerk of that tribunal he captioned the record as "Upon Petition to Review a decision of the Tax Court of the United States".

QUESTIONS PRESENTED [1]

(1) Whether the taxpayer is entitled, under Section 23 (a) (1) of the Revenue Acts of 1936 and 1938, to deduct the full amounts paid to its president, Douglas W. Wilson, as reasonable compensation for services rendered by him to another corporation during each of the taxable years 1936, 1937 and 1938.

[1] A third question—whether the taxpayer sustained a deductible loss in 1938 upon the exchange of a bond for shares of capital stock of different corporations, respectively, under the provisions of Section 112 (b) (5) of the Revenue Act of 1938—was decided by the Board adversely to the taxpayer (R. 45–46), but the taxpayer has abandoned that issue (Br. 2).

(2) Whether the taxpayer is liable, under Sections 351 (a) and 401 (b) of the Revenue Acts of 1936 and 1938, for personal holding company surtaxes for the years 1937 and 1938.

Determinative of this is the question whether any portion of the amounts which the taxpayer paid its president and claimed as a deduction as compensation paid to an officer of the corporation, but portions of which were disallowed by the Commissioner during the years 1937 and 1938, constituted distribution of dividends in those years.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations involved are set forth in the Appendix, *infra*, pp. 30–36.

STATEMENT

The facts as shown by a deposition, several exhibits and a stipulation (R. 53–147), were adopted by the Board of Tax Appeals by reference as its findings of fact (R. 31) and were summarized sufficiently for a determination of the issues herein as follows (R. 31–37):

The taxpayer's income tax returns for the taxable years were filed with the Collector at Los Angeles, California. (R. 31.)

In 1893, one Warren Wilson acquired an unincorporated business called the Daily Journal Company which published the Los Angeles Daily Journal, a California daily newspaper which specialized in legal news. In 1895, the enterprise was incorporated under the laws of the State of California as the Daily Journal Com-

pany, which corporation is the taxpayer herein. (R. 32.)

Warren Wilson acted as president of the corporation from the date of its incorporation to the date of his death, in 1917, at which date and for several years prior thereto he, as the president thereof, received a salary of $24,000 a year. (R. 32.)

In 1917, after the death of Warren Wilson, Douglas W. Wilson, a son (hereinafter referred to as Wilson), who had been connected with the company for a number of years, was elected president thereof and the salary of the president was by resolution of the stockholders reduced from $24,000 to $12,000 a year, at which it has continued, no further corporate action being taken with respect thereto. During the taxable years, 1936–1938, inclusive, taxpayer paid no officers' salaries to anyone except Wilson. (R. 32.)

During the year 1929, and for several years prior thereto, there was serious competition in the legal news and advertising business, in which taxpayer was engaged, between it and the Los Angeles News, the California Independent, the Los Angeles Review and the Greater Los Angeles, which unfavorably affected the income of all these newspapers. At that time the Daily Journal Company, the taxpayer, was doing about two-thirds of the available legal publishing business in Los Angeles. (R. 32.)

The matter of forming a new corporation was discussed by the representatives of the several newspapers mentioned, resulting in 1929 in the incorpora-

tion of the Consolidated Printing & Publishing Company, frequently herein called the "Consolidated", the capital stock of which was issued in exchange for the assets, good will and business of the concerns forming the Consolidated. In connection with the formation of the new corporation, the Consolidated, the parties interested and involved executed certain written agreements indicating therein the general tenor of the proposed consolidation and the interests of the respective parties in the consolidated enterprise. (R. 33.)

The parties to the consolidation understood and agreed that Wilson, who was the president of the Daily Journal Company, would become and continue to act as the president and general manager of the Consolidated. The understanding and agreement described and the execution of the duties imposed on Wilson thereby existed and were discharged by Wilson throughout the years 1936, 1937 and 1938. (R. 33.)

After the organization of the Consolidated was completed, the newspapers then composing the same, but continuing under their own names, were printed and published by the Consolidated and this situation existed throughout the years 1936, 1937 and 1938. (R. 33.)

The stock of the Consolidated Printing & Publishing Company in 1929 was issued in amounts indicated in the schedule below and in the taxable years was held as also shown therein (R. 34):

Name of Stockholder	Shares Received upon Consolidation in 1929			Shares Held In 1936, 1937 and 1938		
	"Class A" Pfd.	"Class B" Pfd.	Common	"Class A" Pfd.	"Class B" Pfd.	Common
L. A. Journal Group: Daily Journal Company	551	3258	2340	----------	3258	2340
L. A. News Group:						
Legal Publishing Company	161	1086	780	----------	----------	----------
C. A. Page	----------	----------	----------	----------	387	560
Marietta Page	----------	----------	----------	----------	193	----------
Chas. A. Page, Jr	----------	----------	----------	----------	193	----------
G. V. Allen	----------	----------	----------	----------	157	110
Ethel Allen	----------	----------	----------	----------	156	110
Calif. Independent Group:						
Dan W. Green	85	469	272	----------	469	272
Marie McManus	3	63	36	----------	63	36
Elmar Riggins	----------	62	36	----------	----------	----------
Forrest A. Riggins	----------	----------	----------	----------	62	36
Kathryn G. Lawson	----------	62	36	----------	62	36
Qualifying shares:						
Douglas W. Wilson	1	----------	----------	1	----------	----------
Wm. W. Roe	1	----------	----------	1	----------	----------
A. A. McDowell	1	----------	----------	1	----------	----------
C. A. Page	1	----------	----------	----------	----------	----------
G. V. Allen	1	----------	----------	----------	----------	----------
Walter F. Haas	1	----------	----------	----------	----------	----------
Frank P. Doherty	----------	----------	----------	1	----------	----------
Treasury Stock	----------	----------	----------	7	----------	----------
	806	5000	3500	11	5000	3500

1. All but qualifying shares of "Class A" preferred stock were retired in 1932 and 1933 pursuant to the stock contract.

The Legal Publishing Company was owned by C. A. Page and G. V. Allen who in 1930 took over that corporation's stock in Consolidated Printing & Publishing Company. Thereafter, in December, 1930, they dissolved the Legal Publishing Company. Subsequently they have distributed part of their holdings to members of their respective families. (R. 34.)

The capital stock of the Daily Journal Company, the taxpayer, was owned in the years and in the amounts shown in the schedule below (R. 35):

Name of Stockholder	Shares held on May 3, 1917 [1]	Shares held on July 1 1929 [2]	Shares held on March 20, 1933 [3]		Shares held during 1936, 1937 and 1938	
			Pfd.	*Com.*	*Pfd.*	*Com.*
Warren Wilson	5					
Wm. W. Roe	5	*5	*15	*5	*15	*5
Wm. W. Roe, Trustee [4]	475					
Mrs. C. M. Wilson	5	*5				
Douglas W. Wilson	10	65	1050	350	1050	350
Walter F. Haas		*5	*15	*5	*15	*5
Cora Wilson Prewett		70				
Clara Wilson Tousley		70	210	70	210	70
Lois Wilson Kinney		70				
Florence Wilson McDowell		70	210	70	210	70
Grace Wilson McLean		70				
Irma Wilson Dorland		70				
	500	500	1500	500	1500	500

[1] May 3, 1917, shortly after the death of Warren Wilson, Douglas W. Wilson was elected President of Daily Journal Company.

[2] The consolidation in 1929 was effective as of July 1, 1929.

[3] On March 20, 1933, Daily Journal Company capitalized $150,000 of earned surplus and issued a preferred stock dividend of 1500 shares of 17% preferred stock.

[4] Trustee for Warren Wilson, Deceased.

*Qualifying Shares.

The agreement between the taxpayer and the Legal Publishing Company, entered into on June 20, 1929, relative to the creation of the Consolidated, provided in part (R. 35–36):

> It is hereby further covenanted and agreed that the executive officers of said new corporation shall not charge or receive any salary for their services rendered to said corporation unless otherwise ordered by the affirmative vote of all of the members of the Board of Directors of said new corporation.
>
> *   *   *   *   *
>
> It is hereby further covenanted and agreed that each of the said contracting parties and the stockholders of said contracting parties so far as the same can be bound by this agreement, will use their best efforts and endeavors to further and promote the business of said new corporation.

During the taxable years 1936, 1937 and 1938, the assets of the taxpayer consisted principally of capital stock of the Consolidated Printing & Publishing Company. Taxpayer had some cash, accounts and notes receivable, and real estate, none of which required any considerable time or service of Wilson with respect to the management thereof, and reasonable compensation for which was $2,000 per year, which is not controverted and was allowed as a deduction by the Commissioner in computing taxpayer's net taxable income. Practically all the taxpayer's income was received from the Consolidated Printing & Publishing Company in the form of dividends on the stock which the taxpayer owned therein. (R. 36.)

The taxpayer in the taxable years owned no printing presses and did not actually print and publish any newspaper. The Los Angeles Daily Journal, however, was printed and published by the Consolidated for the Daily Journal Company. (R. 36.)

Wilson, as contemplated by the agreements heretofore referred to and pursuant to instructions of the stockholders and directors of the taxpayer, devoted practically all his time during the taxable years to the operation and management of the Daily Journal Company and the other papers constituting the Consolidated, the fair value of the services so rendered to the Consolidated being, as agreed by the parties hereto, not less than $12,000 per annum, which amount was paid by taxpayer to Wilson in each of the taxable years. No compensation was paid to Wilson by the Consolidated for his services in managing its affairs. (R. 36–37.)

After the incorporation and organization of the Consolidated, the offices of the Daily Journal and of its president, Wilson, and of the Consolidated, were in the same building and in the same room. The name, Consolidated Printing and Publishing Company, does not appear any place at the offices nor has the Consolidated ever had any letterheads or billheads. So far as the general public is concerned, the newspapers forming or constituting the Consolidated are still published as before the consolidation. (R. 37.)

At no time during the taxable years did Wilson own any Consolidated stock, other than one qualifying share of Class A. (R. 37.)

In computing taxpayer's taxable net income for the taxable years, $10,000 of the $12,000 paid Wilson by taxpayer each year was disallowed by the Commissioner. (R. 37.)

During each of the years 1937 and 1938, the taxpayer paid to its stockholders all dividends received from Consolidated, after deducting operating expenses, as evidenced by the earned surplus balances at the end of 1937 and 1938 of $558.41 and $504.53, respectively. (R. 37.)

During the years 1937 and 1938, taxpayer had gross incomes of $40,851.75 and $26,772.51, respectively, and after paying in each of those years $12,000 as salary to Wilson and other operating expenses, the taxpayer paid out in 1937 and 1938 dividends totaling $29,000 and $13,500, respectively. (R. 37.)

Upon the basis of the foregoing facts the Board, affirming the Commissioner's determination, denied

the deductions for the excessive salaries claimed and the dividends paid credit for the salaries disallowed (R. 41–45), and thereupon entered its decision accordingly (R. 46). From the decision so entered the taxpayer petitioned this Court for review. (R. 148.)

SUMMARY OF ARGUMENT

(1) The statute and regulations do not allow deductions, as ordinary and necessary expenses, for amounts paid by a corporation to its officer as compensation for personal services actually rendered by him directly to another corporation during the taxable year. The Board found that the amounts representing the value of the services rendered for another were properly disallowed by the Commissioner, and determined, upon the evidence, that the portion of the salaries representing a reasonable compensation commensurate with the services actually rendered to taxpayer were allowable. This Court has held that if the salaries paid by a corporation to its officer exceeded the reasonable value of the services actually rendered to it, the corporation may deduct only such amount as found by the Board to be the reasonable value of the services rendered.

There is nothing in the statutes or regulations to indicate that the claimed salaries paid by taxpayer may be deducted by it in connection with the carrying on of another's trade or business. Neither do the facts show that the devotion of the taxpayer's president of practically all his time to the management and operation of Consolidated constituted the *taxpayer's* carrying on the business of the latter. Taxpayer had substantially no more control over Consolidated than did

the other stockholders, all of whom, including taxpayer, were merely indirect beneficiaries, solely through dividends paid them by Consolidated in proportion to their stockholdings, of the increased profits resulting from Wilson's participation in the conduct of the business affairs of Consolidated during the taxable years herein. It cannot be said, therefore, that the taxpayer's payments to Wilson for his services rendered to Consolidated to produce profits for taxpayer and the other stockholders in proportion to their stockholdings, constituted ordinary and necessary expenses paid or incurred in carrying on *taxpayer's* trade or business.

Moreover, since the two corporations were admittedly separate entities and their businesses were separate, distinct and materially different in many respects, there is no basis for the contention that the salaries in question, paid for services rendered to another corporation, constituted taxpayer's expenses of doing business.

(2) No part of the amounts taxpayer paid its president during 1937–1938 constituted a distribution of dividends, and therefore taxpayer is liable for personal holding company surtaxes for those years. Even if the disallowed portions of the excess salaries be considered as dividends, taxpayer is nevertheless not entitled to any dividend-paid credits in the computation of its tax liability for those years. This is true because the claimed distribution was not "pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class", as specifically required by the terms of

the statutes. The amounts in question were paid as salaries and not as dividends, and there is no showing that any portion thereof was authorized as a dividend by taxpayer's directors or stockholders, or that any of the stockholders other than Wilson participated in the payments.

ARGUMENT

I

The taxpayer is not entitled to deduct as ordinary and necessary business expenses for the taxable years 1936–1938 the amounts paid its president, and disallowed by the Commissioner, as compensation for personal services actually rendered by him directly to another corporation during each of those years

The taxpayer's principal asset from 1929 to the taxable year 1938, inclusive, was approximately two-thirds of the outstanding capital stock of Consolidated, the dividends from which constituted almost its sole source of income during the taxable years 1936–1938 involved herein; it owned no printing presses, printed and published no newspapers, having been during that period almost wholly a holding company; the $2,000 yearly portion of the entire salaries which it paid its president was concededly a reasonable compensation for the small portion of his time devoted to the taxpayer's slight business activities; and the $12,000 annual salary paid the president by the taxpayer during each of those years constituted the fair value [2] of his time and services devoted almost entirely

[2] It is stipulated that President Wilson's services to Consolidated were reasonably worth not less than $12,000 per annum (R. 153–154; Pet. Br. 8), as the Board found (R. 42).

to the operation and management of Consolidated, a separate corporation, which printed and published the taxpayer's and others' newspapers. (R. 36, 69–70, 143–144.)

Since the president devoted practically all of his time to Consolidated for which the taxpayer, not Consolidated, paid the entire salaries in dispute (R. 36–37; Pet. Br. 8–9), the question for decision is simply this—whether the taxpayer may properly claim as a deduction, as ordinary and necessary business expenses, the salaries paid its president as the fair value of the services he actually rendered directly to another corporation even though the services performed benefited Consolidated directly but the taxpayer and the several other stockholders of Consolidated only indirectly (that is, through dividend distributions) during each of the taxable years.

The taxpayer contends, substantially as it did before the Board (R. 44), that its business during the taxable years was not merely that of a passive investor but rather it constituted the active operation and management of Consolidated through its officers and employees, particularly its president; and that therefore, corporate equities aside, the amounts paid its president in connection with the carrying on of such business during those years constituted deductible ordinary and necessary business expenses (Br. 13, 18–25).

The Board held that the taxpayer is not entitled to deductions for the claimed salaries as ordinary and necessary business expenses for the reasons that it, merely a two-thirds stockholder of Consolidated,

lacked complete control and domination of the latter and had practically no control over the authorization of its officers' salaries; the $12,000 salary paid the president was conceded by taxpayer's counsel not to be an "ordinary salary"; taxpayer and Consolidated were distinct and separate corporate entities which may not be disregarded or ignored; Consolidated was owned through stock ownership of the taxpayer and others, all of whom received income merely through dividends paid by Consolidated; the salary payments inured to the benefit of the taxpayer, as a stockholder of Consolidated, only indirectly and in proportion to the stockholdings which were equally and proportionately beneficial to the other stockholders of Consolidated; and that taxpayer rendered no such service for Consolidated as to warrant its deducting, as ordinary and necessary expenses of a trade or business, the expenditure incurred. (R. 42–45.) We submit the Board was correct in so holding.

The pertinent statute and regulations allow as deductions for ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business reasonable sums for salaries or other compensation for personal services actually rendered. Section 23 (a), Revenue Acts of 1936 and 1938; Article 23 (a)–6, Treasury Regulations 94, Appendix, *infra.* In this connection, this Court has held substantially that the Board, taking into consideration all the facts and circumstances, may determine as a fact and ascertain what is a reasonable compensation commensurate with the services actually rendered to a corporation by

the person to whom the payment was made; that if the salary paid by the corporation to an officer exceeded the reasonable value of the services actually rendered to it, the corporation may deduct only such amount as found by the Board to be the reasonable value of the services rendered; and that the Board's decision is conclusive if supported by substantial evidence. *Doernbecher Mfg. Co.* v. *Commissioner,* 95 F. 2d 296, 297.

In the present case, the Board found, upon the evidence, that the Commissioner's determination and allowance of deductions for salaries in the amount of $2,000 for each of the taxable years was reasonable and commensurate with the services rendered taxpayer by its president, and therefore approved the determination. (R. 42.) There is ample evidence to support the Board's finding—Wilson was president of both the taxpayer and Consolidated and the services he performed for the business of each were in some respects materially different; taxpayer did not itself print and publish the Los Angeles Daily Journal and owned no printing presses; and in the operation of its business affairs, separate and distinct from the management of Consolidated, comparatively little of the president's time and attention was demanded, required or rendered since practically all of it was devoted to Consolidated. (R. 36, 37, 69–70, 89.) Since the Board found and the evidence shows that the annual allowance ($2,000) made by the Commissioner was commensurate with the services actually rendered to the taxpayer by its president, and the portion thereof

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($10,000) disallowed by the Commissioner exceeded the reasonable value of the services actually rendered to it, it would seem necessarily to follow that, under the rules laid down by this Court in the *Doernbecher* case, taxpayer may deduct only the amount ($2,000) found by the Board to have been the reasonable value of the services rendered to it.

There is nothing express or implied in the statute or regulations to indicate that such expenses may be deducted by the taxpayer in connection with the carrying on of *another's* trade or business. Under taxpayer's theory, however, its interest as a stockholder in Consolidated was so active that its president's devotion of practically all his time and efforts to the management and operation of Consolidated constituted the *taxpayer's* carrying on the business of Consolidated. (Br. 18, 22–23.) Even though there was an understanding and agreement among the parties to the consolidation in 1929 that Wilson would thereafter continue to act, without compensation from Consolidated, as president and general manager of the latter in the printing and publication of all the newspapers theretofore published separately by the several parties to the agreement (R. 33), the fact nevertheless remains that the same was true of all the other officers of Consolidated. It was agreed that none of "the executive officers of said new corporation" would charge or receive any salaries for their services rendered to Consolidated unless otherwise ordered unanimously by the directors (R. 35, 65, 67, 115), and that all of such officers would use their best efforts to further and

promote the business of Consolidated (R. 36, 118–119). There are further facts showing that taxpayer, merely one of the several contracting parties and stockholders, had substantially no more control over Consolidated than the other stockholders. Taxpayer owned only approximately two-thirds of the total outstanding stock of Consolidated and any authorization of salaries for the officers of the latter required the affirmative unanimous vote of the entire board of directors. (R. 34, 35, 43, 65, 67, 144–145.) The purpose of the agreement requiring such unanimous action was to prevent the taxpayer from controlling the policy of Consolidated in respect to salary payments. (R. 66, 67, 68.) Consolidated was owned through the respective stockholdings of the taxpayer and others to the end that each of the parties to the agreement, including the taxpayer, was alike merely an indirect beneficiary, solely through dividends paid by Consolidated in proportion to its stockholdings, of the increased profits resulting from Wilson's participation in the conduct and management of Consolidated during the taxable years herein. (R. 34, 143–145.) Not only did Wilson and the other officers, under the agreement, devote their entire time to the affairs of Consolidated in order to increase its profits for all of its stockholders (R. 33, 36), but Wilson plainly was not required to devote any of his time or efforts to the direct management of the taxpayer's affairs, in spite of which taxpayer, and not Consolidated, paid Wilson the amounts of the salaries in dispute (R. 36–37). Under these facts, it cannot be said that the taxpayer's pay-

ments to Wilson for his services actually rendered to Consolidated to produce profits for the taxpayer and the other stockholders in proportion to their stockholdings, constituted ordinary and necessary expenses paid or incurred during the taxable years in carrying on the *taxpayer's* trade or business. Yet, such is the requirement of the statute and regulations (Section 23 (a) of the Revenue Acts of 1936 and 1938; Article 23 (a)–6 of Treasury Regulations 94) in order that such expense items may be deductible from gross income. *Seufert Bros. Co.* v. *Lucas,* 44 F. 2d 528, 530 (C. C. A. 9th). There this Court stated (p. 530):

> The statute by its terms seems to cover usual or common expenses having relation to *the taxpayer's income,* as distinguished from exceptional and extraordinary outlays. * * * [Italics supplied.]

We submit the foregoing is true since the claimed expenditure on the part of the taxpayer alone, as distinguished from the other stockholders, was neither an ordinary, necessary nor reasonable expense made for the conduct of its own business by reason of the fact that the advantage therefrom flowed not only to the taxpayer but also equally in proportion to the other stockholders who paid no part of the disputed amounts. Consequently, the claimed deductions are not allowable. *Coosa Land Co.* v. *Commissioner,* 29 B. T. A. 389, affirmed in part without discussion of this point, 103 F. 2d 555 (C. C. A. 5th); *Mastin* v. *Commissioner,* 28 F. 2d 748 (C. C. A. 8th); cf. *Welch* v. *Helvering,* 290 U. S. 111; *Keck Investment Co.* v. *Commissioner,* 29 B. T. A. 143, affirmed, 77 F. 2d 244

(C. C. A. 9th), certiorari denied, 296 U. S. 633 (where the Board, in response to the contention that if the taxpayer had not financed the Superior Oil Company, its investment therein would have been lost, stated that the business of the Superior Oil Company was not the business of the taxpayer-stockholder, and that there was no obligation upon the latter to manage the affairs or to contribute to the financial requirements of the corporation); *Menihan* v. *Commissioner,* 79 F. 2d 304 (C. C. A. 2d), certiorari denied, 296 U. S. 651; *Howell* v. *Commissioner,* 69 F. 2d 447 (C. C. A. 8th), certiorari denied, 292 U. S. 654; *Ritter Lumber Co.* v. *Commissioner,* 30 B. T. A. 231; *Security First Nat. Bank of Los Angeles, Executor* v. *Commissioner,* 28 B. T. A. 289; *du Pont* v. *Commissioner,* 37 B. T. A. 1198.

Coosa Land Co. v. *Commissioner, supra,* is a case in point. There the Board, as affirmed, held that the payment made by the taxpayer for the services of a watchman which it employed to guard its subsidiary corporation, of which it was the principal stockholder, was not deductible from its income as a business expense in the year paid. The Board stated (pp. 393–394):

> Respecting this claim, we think it is only necessary to say that it was a business charge of the Alabama Lime & Stone Corporation [the subsidiary] and not an ordinary and necessary expense of the petitioner's business. (See sec. 23 (f) and (g), 1928 Act.) The petitioner was only a stockholder of the Alabama Lime & Stone Corporation. The duty of protecting a corporation's property belongs to it and not

> to the stockholders. The expenditure thus made must be regarded either as a loan to the Alabama Lime & Stone Corporation, or as a capital investment to be added to the cost of petitioner's stock in that company. *Harry E. Lutz,* 2 B. T. A. 484; *John G. Paxton,* 7 B. T. A. 92; *Warren E. Burns,* 11 B. T. A. 524; *B. Estes Vaughn,* 17 B. T. A. 620; *Snider B. Ward,* 18 B. T. A. 326; *W. F. Bavinger,* 22 B. T. A. 1239; *Burns* v. *Commissioner,* 31 Fed. (2d) 399; 280 U. S. 564.

Mastin v. *Commissioner, supra,* is very nearly in point. There a stockholder paid certain sums of money for advertising real estate owned by the corporation because he considered it an advantageous movement for the corporation and its stockholders whereas the other stockholders paid nothing in this connection. Disallowing the deduction claimed by the taxpayer-stockholder as a business expense or a loss, the court said (pp. 752–753):

> In the case of *Mente* v. *Eisner* (C. C. A.) 266 F. 161, 11 A. L. R. 496, the court, in construing a somewhat similar provision in the Revenue Act of 1913 (38 Stat. 114), used the following language in speaking of "losses":
>
> "We think that the language 'losses incurred in trade' are correctly construed by the Treasury Department as meaning in the actual business of the taxpayer, as distinguished from isolated transactions. If it had been intended to permit all losses to be deducted, it would have been easy to say so. Some effect must be given to the words 'in trade'."
>
> *　　　*　　　*　　　*　　　*

As to the payment by petitioner for advertising certain of the real estate belonging to the corpus of the trust estate, the Board of Tax Appeals made the following finding of fact:

"The petitioner in 1919 paid out the sum of $4,245.25 to Brent & Crittenden, real estate agents, for advertising real estate owned by the Mastin Realty & Mining Company. The petitioner owned stock in the corporation but did not own any of the real estate which was to be advertised. The other stockholders of the corporation did not pay out anything in this connection. The petitioner paid out the money because he deemed it an advantageous movement for the corporation and its stockholders. The Mastin Realty & Mining Company and others owned large property interests on the southern border of the principal business district of Kansas City. A movement was started by the parties to advertise this section. The amount so paid to Brent & Crittenden was to be distributed by them."

The payment was therefore made, not by petitioner to advertise his own real estate, not by the corporation to advertise real estate owned by it, but by petitioner as a voluntary one. It was, in our opinion, a capital expenditure, which might enhance the value of petitioner's stock by increasing the value of the lands of the corporation. It was not a loss within the meaning of the statute under discussion. *Duffy* v. *Central R. Co. of N. J.,* 268 U. S. 55, 45 S. Ct. 429, 69 L. Ed. 846.

In *Welch* v. *Helvering, supra,* the Court held that the payments, made by a grain commission agent who

was secretary of a bankrupt corporation engaged in the grain business, to the corporation's creditors for the purpose of strengthening his individual standing and credit and reestablishing his business relations with the corporation's former customers, were not deductible from his income as ordinary and necessary business expenses. The Court stated (pp. 113–114):

> We may assume that the payments to creditors of the Welch Company were necessary for the development of the petitioner's business, at least in the sense that they were appropriate and helpful. *McCulloch* v. *Maryland,* 4 Wheat. 316. He certainly thought they were, and we should be slow to override his judgment. But the problem is not solved when the payments are characterized as necessary. Many necessary payments are charges upon capital. There is need to determine whether they are both necessary and ordinary. Now, what is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance. Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. * * *

In *Menihan* v. *Commissioner, supra,* where the taxpayer made payments to benefit the corporation in which he was the sole stockholder, the court held that the loss sustained by the corporation could not be deducted by such sole stockholder in determining his taxable income. The court stated (pp. 305–306):

> The inquiry comes down to whether or not the payments were deductible losses sustained either

in his trade or business (subdivision (a) (4) of section 214, 26 USCA § 955 (a) (4) * * *. Although the petitioner owned or controlled all of the stock of the Menihan Company, any loss which was incurred in its trade or business was that of the corporation. It was a separate and distinct entity doing business for itself and not as the petitioner's agent. Whatever losses were incurred in that business were deductible, if at all, only from the income of the corporation itself. See *Dalton* v. *Bowers,* 287 U. S. 404, 53 S. Ct. 205, 77 L. Ed. 389. There is no basis appearing in this record for disregarding the corporate structure. The fact that petitioner owned or controlled all of the corporation's stock is alone insufficient ground for that. *American Union Line* v. *Oriental Nav. Corp.,* 239 N. Y. 207, 146 N. E. 338. Indeed, the petitioner insists that the usual distinction between corporation and stockholder should be preserved here, and with that we are in entire agreement.

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The cases relied upon by taxpayer (Br. 16, 18–19, 21) are distinguishable. Thus, *Foss* v. *Commissioner,* 75 F. 2d 326 (C. C. A. 1st), and *Marsch* v. *Commissioner,* 110 F. 2d 423 (C. C. A. 7th), both held substantially that a person who maintains an office where he spends a substantial part of his time and devotes his time to the active management and participation in the management of his properties and companies in which his funds and properties are invested, is carrying on a business within the meaning of the statute permitting deductions for losses and ordinary and necessary business expenses from a trade or business.

Also *Helvering* v. *Highland,* 124 F. 2d 556 (C. C. A. 4th), held that an estate continuing the decedent's activities was engaged in a trade or business so that the expenses of the estate were deductible. Those cases, however, are not in point. Contra, are *Kane* v. *Commissioner,* 100 F. 2d 382 (C. C. A. 2d), and *Miller* v. *Commissioner,* 102 F. 2d 476 (C. C. A. 9th), both holding substantially that the taxpayers' activities in handling their own properties and investments did not constitute a trade or business within the meaning of the statutes authorizing deductions for ordinary business expenses in computing taxable net income. The *Kane* and *Miller* cases are in accord with the rules since laid down by the Supreme Court in *Higgins* v. *Commissioner,* 312 U. S. 212, which in effect overruled such decisions as those relied upon by the taxpayer in the *Foss, Marsch* and *Highland* cases; to the same effect, see *United States* v. *Pyne,* 313 U. S. 127; *City Bank Co.* v. *Helvering,* 313 U. S. 121.

The taxpayer finally states (Br. 23–24) that the Board erroneously thought it was contending that the corporate entities herein should be disregarded but that taxpayer has never even "remotely suggested that such procedure should be followed." While we agree with the taxpayer's statement that such entities should not be ignored herein, as the Board held (R. 44–45), it would nevertheless appear that such admission negatives taxpayer's contention that *its* own business, which produced a very nominal income (Br. 9), was the active business agent through its president in the conduct of Consolidated, a separate corporation (Br.

22). Taxpayer admits that it was merely a holding company and that almost its entire income came from the dividends declared and paid on its Consolidated stock. (Br. 8–9, 10.) Since, therefore, the two corporations were admittedly separate entities (*Inland Development Co.* v. *Commissioner,* 120 F. 2d 986, 988 (C. C. A. 10th)), and their businesses were separate, distinct and materially different in many respects, as the Board found (R. 42) and held (R. 44), there is no basis for the contention that the salaries paid by taxpayer to its president for his services in carrying on the business activities of another corporation constitute allowable deductions as *its* ordinary and necessary expenses of business. They were clearly a proper expense incurred by Consolidated for the conduct of its business in publishing the taxpayer's and the other stockholders' newspapers and therefore deduction of such amounts from the taxpayer's income would clearly amount to the improper distortion of its taxable income. This would be contrary to the provisions of the statute that net income must be computed upon such basis of accounting "as in the opinion of the Commissioner does clearly reflect the income" (Section 41 of the Revenue Acts of 1936 and 1938). Obviously, therefore, if Consolidated, a separate legal entity, required and used the services of taxpayer's president or any other individual for the conduct of its business affairs, it alone and not the taxpayer is entitled, under the taxing statutes, to deduct the expenses thereof. *Seufert Bros. Co.* v. *Lucas, supra,* p. 530; *Menihan* v. *Commissioner, supra,* pp. 305–306.

In view of the foregoing, it seems clear that taxpayer is not entitled to deduct, as ordinary and necessary expenses for the taxable years 1936–1938, the amounts paid its president and disallowed by the Commissioner as compensation for personal services actually rendered by him directly to Consolidated, a separate corporation, during those years.

II

No part of the amounts taxpayer paid its president during the taxable years 1937–1938 constituted a distribution of dividends, and therefore taxpayer is liable for personal holding company surtaxes for those years

Taxpayer further contends that regardless of the deductibility of the salaries claimed, it accumulated no earned surplus during the years 1937–1938 since the portion of the salaries paid to Wilson and disallowed by the Commissioner constituted a distribution with the result that it is not liable for personal holding company surtaxes on any amount for those years. (Br. 26–28.)

The Board held that the taxpayer is not entitled to any dividend-paid credit in the computation of its tax liability because even though the excess disallowed salaries be considered as dividends, they were not within the purview of the statutes authorizing such credits, and consequently it is liable for the surtaxes as asserted by the Commissioner. (R. 45.)

The pertinent statutes levy surtaxes upon the undistributed adjusted net income of personal holding companies. Section 1 of the Revenue Act of 1937, amending Section 351 of the Revenue Act of 1936,

Appendix, *infra;* Section 401 of the Revenue Act of 1938, Appendix, *infra.* They provide for dividend-paid credits against income to the extent of dividends paid during the taxable year (Section 27(a), Revenue Act of 1936, Appendix, *infra*), but they also provide further as follows (Section 27(g), Revenue Act of 1936, Appendix, *infra*):

> *Preferential Dividends.*—No dividends paid credit shall be allowed with respect to any distribution unless the distribution is pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class.

Under the specific wording of the statutes, therefore, even though the disallowed portions of the excess salaries be considered as dividends, the taxpayer is nevertheless not entitled to any dividend-paid credit in the computation of its tax liability for the years in question for the reason that the claimed dividend distribution was not "pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class" (Section 27(g)) as the Board properly held. (R. 45.)

Even though this result may be inequitable and is allegedly not within the spirit of the statute, as taxpayer states (Br. 26–27), the fact nevertheless remains that the terms of the statutes are specifically applicable and controlling herein and must therefore be given effect. The record is clear that the amounts in question were paid to taxpayer's President Wilson as salaries and not as dividend distributions. There is no showing that any portion thereof was authorized

as a dividend by the taxpayer's directors or stockholders, or that any of the stockholders, other than Wilson, participated in the payments. Dividend-paid credits are not allowable under Section 27 in any event where the distribution is not pro rata alike to all the shareholders. *May Hosiery Mills, Inc.* v. *Commissioner,* 123 F. 2d 858 (C. C. A. 4th). Moreover, disallowance by the Commissioner of salaries paid by a corporation to its officers does not transmute the amount disallowed into a dividend. *Hayner* v. *United States,* 62 C. Cls. 189.

Pembroke Realty & S. Corp. v. *Commissioner,* 122 F. 2d 252 (C. C. A. 2d), relied upon by taxpayer (Br. 27–28), is not in point. There the taxpayer had net income for the taxable year of more than $87,000, and at the end of the year dissolved and distributed all its assets to its shareholders. The court held that the distribution was a dividend as defined in Section 115 (a) of the Revenue Act of 1934—any distribution made by a corporation to its shareholders out of its earnings or profits accumulated after February 28, 1913—and that therefore the Revenue Act of 1934 did not impose the surtax upon the corporation which had distributed all its property to its stockholders. The provisions of the Revenue Act of 1934, however, were very different from those of the Revenue Acts of 1936, 1937 and 1938 involved in the instant case where dividend-paid credits are specifically not allowable under the facts herein.

Accordingly, we submit that the taxpayer is liable for the personal holding company surtaxes herein

since no part of the amounts it paid its president during the taxable years 1937–1938 constituted a distribution of dividends within the meaning of the pertinent statutes.

CONCLUSION

The decision of the Board of Tax Appeals in respect to both Points I and II, *supra,* is correct and in accord with law and the authorities. It should therefore be affirmed.

Respectfully submitted,

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January, 1943.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

SEC. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) *Dividends Paid Credit in General.*—For the purposes of this title, the dividends paid credit shall be the amount of dividends paid during the taxable year.

* * * * *

(g) *Preferential Dividends.*—No dividends paid credit shall be allowed with respect to any distribution unless the distribution is pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class.

* * * * *

SEC. 351. SURTAX ON PERSONAL HOLDING COMPANIES.

*   *   *   *   *

(b) *Definitions.*—As used in this title—

*   *   *   *   *

(2) The term "undistributed adjusted net income" means the adjusted net income minus the sum of:

*   *   *   *   *

(C) The amount of the dividends paid credit provided in section 27, computed without the benefit of subsection (b) thereof (relating to the dividend carry-over).

*   *   *   *   *

Revenue Act of 1937, c. 815, 50 State. 813:

TITLE I—PERSONAL HOLDING COMPANIES

SEC. 1. AMENDMENT OF 1936 ACT.

Title IA of the Revenue Act of 1936 is amended to read as follows:

"TITLE IA—ADDITIONAL INCOME TAXES

"SEC. 351. SURTAX ON PERSONAL HOLDING COMPANIES.

"There shall be levied, collected, and paid, for each taxable year (in addition to the taxes imposed by Title I), upon the undistributed adjusted net income of every personal holding company a surtax equal to the sum of the following:

"(1) 65 per centum of the amount thereof not in excess of $2,000; plus

"(2) 75 per centum of the amount thereof in excess of $2,000.

*   *   *   *   *

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 23. DEDUCTIONS FROM GROSS INCOME. In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *In General.*—[Section 23 (a) (1) of this Revenue Act is the same as Section 23 (a) of the Revenue Act of 1936] * * *.

* * * * *

SEC. 27. CORPORATION DIVIDENDS PAID CREDIT.

* * * * *

(b) *Basic Surtax Credit.*—As used in this title the term "basic surtax credit" means the sum of:

(1) The dividends paid during the taxable year, increased by the consent dividends credit provided in section 28, and reduced by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations;

* * * * *

(h) *Preferential Dividends.*—The amount of any distribution (although each portion thereof is received by a shareholder as a taxable dividend), not made in connection with a consent distribution (as defined in section 28 (a) (4)), shall not be considered as dividends paid for the purpose of computing the basic surtax credit, unless such distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference. For a distribution made in connection with a consent distribution, see section 28.

* * * * *

SEC. 401. SURTAX ON PERSONAL HOLDING COMPANIES.

There shall be levied, collected, and paid, for each taxable year, upon the undistributed Title IA net income of every personal holding company (in addition to the taxes imposed by Title I) a surtax equal to the sum of the following:

(1) 65 per centum of the amount thereof not in excess of $2,000; plus

(2) 75 per centum of the amount thereof in excess of $2,000.

*   *   *   *   *

SEC. 403. PERSONAL HOLDING COMPANY INCOME.

For the purposes of this title the term "personal holding company income" means the portion of the gross income which consists of:

(a) Dividends, interest (other than interest constituting rent as defined in subsection (g)), royalties (other than mineral, oil, or gas royalties), annuities.

*   *   *   *   *

SEC. 405. UNDISTRIBUTED TITLE IA NET INCOME.

For the purposes of this title the term "undistributed Title IA net income" means the Title IA net income (as defined in section 406) minus—

(a) The amount of the dividends paid credit provided in section 27 (a) without the benefit of paragraphs (3) and (4) thereof (computed without its reduction, under section 27 (b) (1), by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations); but, in the computation of the dividends paid credit for the purposes of this title, the amount allowed under subsection (c) of this section in the computation of the tax under this title for any preceding taxable year shall be considered as a dividend paid in such preceding taxable year and not in the year of distribution;

*   *   *   *   *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

> Art. 23 (a)–6. *Compensation for personal services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:
>
> (1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (a) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (b) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.
>
> (2) The form or method of fixing compensation is not decisive as to deductibility. While

any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

ART. 23(a)–7. *Treatment of excessive compensation.*—The income tax liability of the recipient in respect of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the payor, will depend upon the circumstances of each case. Thus, in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stock holdings, and are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend. If such payments constitute payment for property, they

should be treated by the payor as a capital expenditure and by the recipient as part of the purchase price. In the absence of evidence to justify other treatment, excessive payments for salaries or other compensation for personal services will be included in gross income of the recipient and subjected to both normal tax and surtax.

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